STATE BOARD OF EQUALIZATION
STAFF LEGISLATIVE BILL ANALYSIS

Date Amended:	**03/09/00**	Bill No:	**SB 1377**
Tax:	**Sales and Use**	Author:	**Haynes**
Board Position:	**Neutral**	Related Bills:	**AB 2188 (Baldwin)**

BILL SUMMARY:

This bill would provide a sales and use tax exemption for any tangible personal property ordered over the Internet.

ANALYSIS:

Current Law:

Under existing law, the sales tax or the use tax applies to the sale or use of tangible personal property in this state, unless specifically exempted by law. The application of sales and use tax with respect to Internet transactions is no different than the application of sales and use tax with respect to mail order transactions or any other sales or purchases where an order for merchandise is made. The Internet is simply a medium by which an order may be placed – similar to a telephone order. Therefore, if a California consumer places an order over the Internet with a California retailer, or an out-of-state retailer that is engaged in business in California, the sales or use tax applies, depending on the place in which the goods are shipped. Generally, if the goods are shipped from the California retailer's store or other place within California to the customer, the California sales tax applies just the same way as any other sale in California. If the goods are shipped from an out-of-state point, the California use tax applies. If the out-of-state retailer has no physical presence in California and is not registered to collect the California use tax, then the California customer is required to self-report the use tax to the Board by the end of the month following the quarterly period in which the purchase was made. If the out-of-state retailer has physical presence in California, such as a place of business or a sales representative, that retailer is required to collect the California use tax and remit the tax to the Board on all sales made to California consumers not otherwise exempt from tax.

Proposed Law:

This bill would add Section 6363.1 to the Sales and Use Tax Law to create an exemption from sales and use tax for any orders of tangible personal property over the Internet.

The bill would become effective immediately, however, the provisions would become operative on the first day of the calendar quarter commencing more than 90 days after the bill becomes law.

COMMENTS:

1. **Sponsor and purpose.** This measure is sponsored by the author and is intended to establish a sales and use tax exemption for sales and purchases over the Internet in order to guarantee the continued growth of Internet commerce in California.
2. **The March 9, 2000 amendments clarify that the exemption would apply to any tangible personal property ordered over the Internet.** In the introduced version of this measure, the bill would have provided a sales and use tax exemption for sales and purchases over the Internet. Since a sale does not occur until the seller completes his or her performance with respect to delivery of the goods, the language contained in the introduced version would not have achieved the desired results.
3. **Exemption could become very broad.** The proposed exemption would enable *any retailer*, whether a California retailer or an out-of-state retailer, to set up a site on the Internet and funnel all orders through the Internet in order to avoid payment of the California sales or use tax. The bill would enable, for example, sales personnel to place orders on the Internet site on behalf of walk-in or mail order customers so as to obtain the benefit of the proposed tax exemption. If this is not consistent with the author's intent, staff is willing to work with the author's office to draft any amendments that would achieve the goal of the measure.
4. **Similar state and federal legislation is pending.** AB 2188 (Baldwin), as introduced February 23, 2000, would also exempt all purchases over the Internet. And on the federal level, Sen. No. 1611 has been introduced by Senator John McCain, Chairman of the Committee on Commerce, Science, and Transportation, on September 22, 1999. This legislation would, among other things, make the federal moratorium on taxation of e-commerce permanent and would prohibit the imposition of sales and use taxes by state and local governments on sales of domestic or foreign goods or services acquired through electronic commerce. Sen. No. 1611 has been referred to the Committee on Commerce, Science, and Transportation.

COST ESTIMATE:

Costs would be incurred in notifying all possibly affected retailers, amending the regulations, verifying claimed exemptions and answering inquiries. An estimate of these costs is pending.

REVENUE ESTIMATE:

Background, Methodology, and Assumptions

For purposes of this estimate, we assume that no major changes in taxpayer behavior would be caused by this bill. For example, it appears that under this proposal a purchaser could avoid paying sales or use taxes when purchasing a car by negotiating the purchase of the car on the dealer's premises in person and then placing the actual order for the car over the Internet. It appears this could be true even if the purchaser thereafter took possession of the purchased car at the dealer's premises. While such transactions would almost certainly become commonplace under this bill as currently drafted, we base our estimate on the assumption that they will not be. This is discussed further below.

On January 31, 2000, the Legislative Analyst's Office (LAO) published a report, *California Tax Policy and the Internet*. Supplement D-3 to that report discusses revenue impacts of electronic commerce sales in California.[1] BOE staff relied heavily on this report in making these revenue estimates. According to Supplement D-3, recent estimates of total U.S. electronic commerce were in excess of $100 billion for 1999. We assume this $100 billion figure in making these revenue estimates. Of this amount, the LAO states that the business-to-consumer retail segment of this total ranges from $20 billion to $36 billion. We assume a mid-range estimate of $28 billion in U.S. business-to-consumer sales for 1999. The $72 billion in sales remaining from the $100 billion total are assumed to be U.S. business-to-business.[2]

(1) Business-to-Consumer Revenues. A large part of U.S. consumer Internet purchases are for financial services, travel, and other transactions not subject to sales and use taxes. Data from three different sources indicate that approximately 40 percent of U.S. consumer Internet sales are subject to sales and use taxes in typical state tax systems.[3] The California sales and use tax base is similar to that of most U.S. consumers. About a year ago a memo from BOE staff made illustrative example estimates of California Internet sales and use tax revenue losses.[4] In making these estimates, BOE staff also assumed

---

[1] We will use the terms "Internet sales" and "electronic commerce sales" interchangeably throughout this discussion.

[2] The term "business-to-business," as used here, includes sales of goods and services from businesses to government agencies.

[3] The sources are Ernst and Young, Boston Consulting Group, and Forrester Research Incorporated. Article Sources: (1) Ernst and Young (http://www.ey.com), *The Sky is Not Falling: Why State and Local Revenues Were Not Significantly Impacted by the Internet in 1998*, June 18, 1999 (2) The Boston Consulting Group and Forrester Research Incorporated are both cited in the *National Tax Journal,* Volume 52, Number 3, September 1999, pp. 413-428, "Evaluating the Costs and Benefits of Taxing Electronic Commerce," Austan Goolsbee and Jonathan Zittrain. (This article is also on Dr. Goolsbee's web site, http://gsbadg.uchicago.edu.) Note: The 40% figure was not cited by the authors. Instead, BOE staff calculated the taxable portions using judgment and the figures provided in Tables 2A and 2B of the article.

[4] Memo from Jeff Reynolds, BOE Agency Planning and Research Division, Statistics Section, to Honorable Dean Andal, "Internet Sales," March 16, 1999.

that 40 percent of consumer Internet sales were subject to sales and use taxes, following the national pattern.

In that same memo, BOE staff assumed that about 50 percent of taxable Internet purchases in California were made from sellers with nexus in California. We will continue to make this assumption, having no evidence to support changing it. As in the memo, we will also assume that California Internet sales to consumers are about 15 percent of the national Internet sales to consumers. This is a slightly higher percentage than our 12 percent share of national population, which is an adjustment for the likelihood that California consumers may be more likely than consumers in the rest of the nation to make purchases over the Internet.

With all the above assumptions, an estimate of 1999 California Internet sales for sellers with nexus is approximately $840 million (28 billion in U.S. Internet sales x 1000 (to put the final figure in millions) x 0.40 x 0.50 x 0.15 = 840 million). The state, local, and transit district taxes on this amount are $66.5 million assuming an average statewide rate of 7.92 percent (0.0792 x 840 = 66.5).

(2) <u>Business-to-Business Taxable Sales.</u> As mentioned earlier, we will assume $72 billion in U.S. business-to-business Internet sales for 1999. As with consumers, we will assume California sales are 15 percent of the total. Unlike the business-to-consumer market, we will assume *all* businesses with nexus in California pay sales or use taxes on their purchases, whether or not the supplier has nexus in California.

Therefore, California business-to-business Internet sales are estimated to have been approximately $10.8 billion in 1999 (72 x 0.15 = 10.8). Only part of these sales are likely to be subject to sales and use taxes because sales of intermediate goods (sales for re-sale) are not subject to taxation. The volume of such sales is substantial. Before a tangible item such as a shirt, reaches the final consumer, sales are made of cotton, cloth, dyes, thread, and other materials. In calculating gross domestic product (GDP), the value of such intermediate goods is subtracted out to avoid double counting. However, in calculating the total volume of business-to-business sales, these sales need to be included to make valid comparisons to Internet sales estimates. This is because intermediate transactions are included in the Internet business-to-business sales estimates.

Unlike sales for final consumption, there is relatively little data available on intermediate transactions from the U.S. Department of Commerce. Intermediate transactions are much more difficult to estimate because one needs specific data for each of potentially many intermediate transactions, depending on the nature of the product and the type of distribution system used. Data from the U.S. Department of Commerce indicate that intermediate inputs were about 75 percent of GDP in 1992, the latest year for which such data are available. Applying this percentage to 1999 GDP of $9,248 billion yields an estimate of $6,936 billion in U.S. intermediate transactions (9,248 x 0.75 = 6,936).

In addition to sales of intermediate goods, business-to-business sales include sales of goods where the final user is a business or a government agency. These are the investment and government investment components of GDP, which totaled $1,918 billion in 1999. Together, business-to-business transactions are estimated to be the sum of these two components (intermediate and final transactions), a total of $8,854 billion in 1999 (6,936 + 1,918 = 8,854).

However, some of this value is imputed, that is to say, no market transactions take place. Imputed transactions need to be subtracted out of this total. From a list of imputed transactions provided by the U.S. Department of Commerce, BOE staff estimates that about 9 percent of business and government transactions were imputed in 1998. If this percentage applies to 1999 GDP, $832 billion would need to be subtracted (9,248 x .09 = 832). Therefore, total U.S. business-to-business transactions are estimated to have been $8,022 billion (8,854 - 832 = 8,022). Assuming a California share of 12 percent, this yields an estimate of statewide business-to-business transactions of $963 billion (8,022 x 0.12 = 963 billion).

A widely used rule-of thumb is to assume that about one third of all taxable sales are sales to businesses and governments.[5] Using the Governor's Budget Forecast for fourth quarter taxable sales, taxable sales are estimated to have been approximately $390.4 billion in 1999.[6] The business portion of sales is therefore estimated to have been approximately $129 billion (390.4 x 0.33 = 128.8). These sales are about 13 percent of all California business-to-business transactions estimated earlier (129 / 963 = 0.13).

As mentioned earlier, California business-to-business Internet sales are estimated to have been approximately $10.8 billion (10,800 million) in 1999. If one assumes that the same 13 percent taxable portion of all business-to-business sales also applies to Internet business-to-business sales, the estimated associated use tax revenues are approximately $111 million (10,800 million x 0.13 x 0.0792 = $111.2 million).

Revenue Summary

The state, local, and transit district revenue losses associated with California business-to-consumer Internet sales for retailers with nexus are estimated as follows:[7]

[5] Source: Phone call discussions with Department of Finance staff held in 1996, when Finance was developing its dynamic revenue estimation model. The consumer and business portions were crosschecked for reasonableness by calculating relationships between U.S. taxable consumption goods (as determined by BOE staff) and GDP and comparing these to two-thirds of total taxable sales as a percent of gross state product (GSP), as estimated by the UCLA Anderson Economic forecast of December 1999. In both cases, taxable consumption was approximately 20 percent of total output as measured by GDP and GSP, respectively.

[6] BOE data indicate that taxable sales were $358,858 million in 1998. The governor's budget forecasted 8.8 percent growth for 1999, or taxable sales of $390,438 million.

[7] "Transit" districts, as defined here also include a variety of other special purpose districts, such as library districts.

State Loss (5%)	$42.0 million
Local Loss (2.25%)	$18.9 million
Transit Loss (0.67%)	$5.6 million
Total	$66.5 million

The state, local, and transit district revenue losses associated with California business-to-business Internet sales are estimated as follows:

State Loss (5%)	$70.2 million
Local Loss (2.25%)	$31.6 million
Transit Loss (0.67%)	$9.4 million
Total	$111.2 million

The total state, local, and transit district sales and use tax revenue impacts of this bill is a loss of approximately $178 million in 1999 (66.5 + 111.2 = 177.7).

Qualifying Remarks

Currently, there are several private research organizations making estimates and forecasts of electronic commerce sales. There is considerable variation among them in definitions and related dollar amount estimates of U.S. electronic commerce sales for 1999. These differences are magnified in forecasts over the next several years. We also recognize that this is a very fast-changing area, and that new forecasts could be issued at any time.

While Internet commerce sales estimates vary, most researchers who have studied the subject agree that their future growth is likely to be exponential in the years ahead. Therefore, the revenue impacts estimated here for 1999 are likely to increase significantly over the next several years.

In addition to these private sector estimates, in early March the U.S. Department of Commerce issued its first quarterly estimate of retail U.S. electronic commerce sales for the fourth quarter of 1999. This figure is smaller than comparable estimates made by private firms, largely because the definitions of retail sales are different. While this is an official government data source, basing a revenue estimate on it requires as many assumptions of unknown information as using sales estimates made by private firms. Making some reasonable assumptions, using the Commerce fourth quarter figure results in an estimate of business-to-consumer annual revenue loss of approximately $64 million instead of $66.5 million for 1999. The relatively small $2.5 million difference in the two estimates is well within an expected order of magnitude for using such independent data sources, and it verifies the reasonableness of our original projection. (The $64 million estimate for California based on the U.S. Department of Commerce figure is subject to change for two reasons. First, if new information becomes available to us from private industry, some of our assumptions may change. Second, the Commerce figure itself is preliminary, and is subject to revision.)

Many assumptions needed to be made in this analysis due to unavailability of both internal and external data. The most critical assumptions are those made for U.S. and California intermediate business-to-business transactions, California nexus, and the types of goods and services being transacted using the Internet. Changes in any one of these assumptions can add or subtract several tens of millions of dollars to these estimates.

As mentioned, changes in taxpayer behavior caused by this bill were not considered. If taxpayer behavior changes, it is possible that the revenue losses could be many times higher than these estimates. For example, suppose 25 percent of consumers use the Internet to purchase a car to avoid paying sales and use taxes, as discussed earlier. In 1998, California new car sales were $34.2 billion (34,200 million). Using an average statewide tax rate of 7.92 percent, the associated revenue loss would be $677 million (34,200 million x 0.25 x 0.0792 = $677 million).

Analysis prepared by:	Sheila T. Sarem	445-6579	03/13/00
Revenue estimate by:	Joe Fitz	445-0840	
Contact:	Margaret S. Shedd	322-2376	

This staff analysis is provided to address various administrative, cost, revenue and policy issues; it is not to be construed to reflect or suggest the Board's formal position.